VZCZCXRO6908
PP RUEHAG RUEHROV RUEHSR
DE RUEHDL #0042/01 0281336
ZNY CCCCC ZZH
P 281336Z JAN 09
FM AMEMBASSY DUBLIN
TO RUCNMEM/EU MEMBER STATES PRIORITY
RUEHC/SECSTATE WASHDC PRIORITY 9723
INFO RUEHBL/AMCONSUL BELFAST 0869
RUEATRS/TREASURY WASHDC

C O N F I D E N T I A L SECTION 01 OF 02 DUBLIN 000042

SIPDIS

E.O. 12958: DECL: 01/28/2019
TAGS: PGOV PREL ECON EFIN EI
SUBJECT: IRISH ECONOMIC OUTLOOK: AS BLACK AS THE GUINNESS

REF: A. DUBLIN 31
¶B. 08 DUBLIN 653 AND PREVIOUS

DUBLIN 00000042 001.2 OF 002

Classified By: Pol/Econ Section Chief Ted Pierce; reasons 1.4(b/d).

¶1. (C) Summary: On the heels of the nationalization of Anglo Irish Bank (Ref A), two other leading Irish banks continued to stumble and a prominent consumer bank laid off 750 employees. In order to calm a jittery market, Finance Minister Brian Lenihan moved forward the planned recapitalization of the banks and ruled out nationalization as an option. The government's own finances are in poor shape with total financing requirements of Euro 26 billion in ¶2009. The government has options open to it to fund this gap but, according to Prime Minister Brian Cowen, must cut expenditures by Euro 15 billion over the next five years to ensure the government debt does not get out of control. The 2009 numbers for the real economy are not promising: four percent fall in GDP; deflation of 3.5 percent; and double-digit unemployment. While in no danger of falling, the Irish government has taken a substantial hit in the court of public opinion over its handling of the economic crisis. To restore confidence, the government must begin to act proactively rather than simply react to each tranche of dismal economic data. End Summary.

Banking Developments

¶2. (U) Following the nationalization of Anglo Irish Bank (Ref A), the two largest Irish banks have exhibited further signs of weakness. Allied Irish Bank's (AIB) share price has fallen to $1.76 from a 52 week high of $47.72 and Bank of Ireland (BOI) has fallen to $1.69 from a 52 week high of $63.72. On January 19, the Bank of Ireland announced the resignation of its CEO, Brian Goggin.

¶3. (SBU) In light of these developments, on January 22, Minister for Finance Brian Lenihan indicated that the planned recapitalization of the banks, originally scheduled to occur by the end of March, would be accelerated. Lenihan stated that there are currently no proposals to nationalize AIB or BOI. However, he declined to rule out the possibility. Under the recapitalization plan the government will provide euro 2 billion to each bank, with each bank on the hook to raise another euro 1 billion on the capital markets. With the share price collapse, it looks likely that the banks will not be able to raise this capital, which obligates the government to step in and provide it. In order to avoid taking a majority position in either bank, the State will likely opt to take preference shares (carrying a fixed annual dividend) over ordinary shares. In addition to the recapitalization, the Government is likely to adopt a proposal whereby bad loans from AIB and BOI would be transferred to Anglo Irish Bank.

¶4. (U) Since January 20, AIB trading volumes have increased dramatically, with 45 million shares traded on January 21, as compared to an average volume of one million shares. Industry analysts believe that someone has acquired a 4 percent stake and that the bank may be an acquisition target.

The Government's Finances

¶5. (C) Nationalizing Anglo Irish Bank will not immediately affect the government's financial position. The government has classified the bank as a commercial semi-state company, which means that the Irish government does not include the company's debt on its books. However, if the government chooses to inject capital or write off some of the bank's bad debts, this would be counted as a government expenditure. As of end-2008, the government's debt stood at euro 76.3 billion, which equates to a debt/gross domestic product (GDP) ratio of 41 percent. While low compared to many other EU Member States, the worry among economists is that this ratio is getting too large, too fast. Rossa White, chief economist at Davy Stockbrokers, told us that he expects that the Irish government will need to come up with about euro 26 billion in 2009 (and possibly 2010) to finance the deficit and the bonds coming due.

¶6. (SBU) Financing this imbalance will be a challenge but one that should be manageable for the government. White points out that the Irish government already sold euro 6 billion of 5-year bonds on January 8th, effectively funding one-quarter of this euro 26 billion. The yield on the bonds was a low 4.06 percent, which bodes well for future forays into the capital market. The fact that Fitch has maintained Ireland's "AAA" sovereign debt rating will aid in keeping refinancing costs down. Further, the National Treasury Management Agency

(NTMA), the government's debt manager, raised euro 20 billion in cash from the sale of commercial paper in 2008. If the government has difficulty raising capital in the bond markets, it can always resort to second-best options such as liquidating the euro 15 billion in the National Pensions Reserves Fund (NPRF) -- a pot of money built up through annual injections of government revenue during the boom years.

¶7. (C) That said, running such sizable yearly deficits is not sustainable. The debt service burden for 2009 alone will be 12-15 percent of tax revenue, rising to (at least) 17-20 percent in 2010. While still far short of the debt service burden during Ireland's "crisis" period in the 1980s (the measure stood at 35.2 percent in 1985), a consensus is developing that the government needs to cut spending to shrink the yearly deficits. Prime Minister Brian Cowen intends to do just that, stating that euro 15 billion needs to be cut over the next five years. In 2009, Finance Minister Brian Lenihan is looking to cut spending by euro 2 billion, a large chunk of which is expected to come from public sector pay cuts. Anecdotally, most public sector employees Econoff has spoken to are resigned to taking some amount of cut in pay over the next year or two.

Real Economy: GDP and Prices Fall; Unemployment Spikes
-- ---------

¶8. (C) If the government is facing harsh circumstances, the real economy is not expected to fare much better. GDP is expected to fall by 4 percent in 2009, the largest ever one year output decline in Ireland's modern history. Most economists expect output to shrink in 2010 but some have told us frankly that the environment is just too volatile to have much confidence in these predictions.

¶9. (C) The risk of deflation remains very real. According to Ulster Bank figures, the 2008 average inflation rate was 4.1 percent but prices in December fell by 1.2 percent. Most of

this fall was accounted for by severe dips in energy and interest rates. Pat McArdle, chief economist at Ulster Bank, said that the consumer price index (CPI) will remain negative for all of 2009, bottoming out with a price level decrease of 3.5 percent in August/September.

¶10. (U) The number of people receiving some kid of jobless benefit rose from 172,400 in December 2007 to 293,500 in December 2008 -- up a record 70 percent for the year. The unofficial estimate of the unemployment rate is 8.3 percent. This rate is expected to get worse as the economy contracts, with most economists predicting unemployment to reach 11 to 13 percent by the end of 2009. Company layoffs have become a headline event with firms such as Dell and, more recently, Ulster Bank shedding hundreds of employees (750 in the case of Ulster Bank). Microsoft reps told us that the company's planned global job cuts will have "some" effect on the Ireland operations. Even the iconic Irish company Waterford Crystal filed for bankruptcy recently.

Comment

¶11. (C) The economy is the main topic of conversation wherever one goes. There is an undercurrent of anger at the government for its perceived "squandering" of the gains made during the Celtic Tiger years. While clearly anecdotal, more and more of our private-sector contacts are beginning to question the ability of the current economic team to handle the multiple challenges facing the government. That said, there is very little danger of the government falling. There is clearly a widespread desire for government to lead the nation's way out of this crisis rather than to simply react to each tranche of dismal economic data.
FAUCHER